

Written Testimony of Neal Spencer, Managing Partner of **BKD, LLP**
The Department of the Treasury
Advisory Committee on the Auditing Profession
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Chairmen Levitt and Nicolaisen and members of the Committee:

Thank you for the opportunity to address the Committee on the topic of Auditing Profession Structure: Competition, Concentration, Independence and Other Professional Standards.

With annual revenues of approximately \$320 million and 1,900 total personnel, **BKD, LLP** is the 10th largest public accounting firm in the United States, according to Public Accounting Report. We currently audit approximately 85 SEC registrants, including 30 benefit plan audits. While the opinions I express are mine and those of my firm, the issues I will address are those faced by a number of local and regional public accounting firms every day as they look to expand their presence in auditing public companies. I would encourage the Committee to expand its efforts to reach out to other local and regional CPA firms as part of this process. While I do not presume to speak on behalf of these firms, many of the barriers to entry or expansion of service in the public company audit market I will discuss may be echoed by my peers across the country.

Concentration in Public Company Auditing

Concentration in public company auditing is a potentially serious issue. As I'm sure you are aware, the four largest public accounting firms audit 78% of U.S. public companies, and those companies represent 99% of U.S. public company revenues. While the levels of competition and concentration among auditors of small public companies have improved in recent years, significant concentration among auditors of large and mid-size public companies still exists. The impact to the capital markets of the departure of one or more of the largest public accounting firms from the market would be significant. Regional and local accounting firms would be able to perform the audits of at least some of the small and mid-size clients of a failed large accounting firm, and if certain circumstances change as discussed further herein, would likely invest in resources necessary to expand their ability to do so. We believe that regional and local firms do not currently have the resources (or perhaps the desire) to take on the audits of large public companies.

Analysis

There are a number of barriers to expanding the number of firms competing in the public company auditing market:

1) Resources

The resources necessary to audit many large public companies are immense, both in terms of quantity and expertise. Many firms outside of the four to six largest firms do not have the resources and expertise to audit large public companies.

Many regional and local firms, including BKD, do not have robust international affiliations to draw upon to audit multinational companies. While many such firms belong to international affiliations or alliances of firms, these international affiliations do not generally provide the breadth or depth of expertise necessary to audit large multinational companies.

Many of these affiliations do not require member firms to use consistent audit methodologies or quality control policies and procedures and lack monitoring mechanisms to help the U.S. member firms monitor (or automatically assume) the overall quality of the work performed by international members. While U.S. firms are required under existing professional standards to perform sufficient work to be able to accept responsibility for such work or divide responsibility with the member firm as appropriate, this level of oversight would be difficult, if not impossible, for many regional and local firms to apply in audits of large multinational companies.

Another resource constraint is industry expertise. Specialized accounting and operational knowledge is necessary to effectively audit certain industries. As the GAO has identified in its studies, even among the four largest accounting firms, expertise in certain industries is concentrated in one to three of those firms.

For many regional and local firms, developing and maintaining a public company audit practice requires a disproportionately large allocation of time and effort on the part of firmwide quality control personnel and audit teams. There are a number of reasons for this:

- Because most work performed by these firms is for nonpublic companies, their public company auditors must understand and be able to apply two sets of accounting rules and two sets of auditing rules, as many of these firms do not have the critical mass of public company audit work necessary to allow these auditors to focus solely on public company work
- Firmwide quality control personnel must develop and maintain quality control systems to address the requirements of both public and nonpublic audits
- Much of the SEC's interpretive guidance to issuers and public company auditors is not transparent to the public or to the public accounting profession at large. The SEC frequently communicates positions in speeches or in other means that are not public record. Firms such as BKD that do not have a presence in New York or Washington, D.C., or that are not otherwise present for this dissemination, have limited or no access to such information. While groups like the Center for Audit Quality have helped improve this transparency in recent years, more needs to be done

2) **Institutional Bias**

While perhaps not popular to discuss, in reality there is substantial bias on the part of much of the underwriter, institutional investor and registrant communities toward use of the four to six largest accounting firms. Some of this bias likely comes from

concerns regarding resources and industry expertise, which are appropriate concerns. However, there are other factors that may play into this bias which are less appropriate.

- Lack of experience with firms other than the four to six largest firms
- Perceived lack of auditors' deep pockets

Audit committees have a responsibility to select a qualified, reputable auditing firm. To expand the pool of potential public company audit firms, inappropriate institutional biases must be identified and addressed, especially where those biases are driven by perceived lack of resources and expertise or the perceived need for a financial safety net for potential claims.

3) **Insurability**

Most public accounting firms use professional liability insurance as a primary tool to help manage liability risk. BKD, along with most regional and local firms, is fortunate to have access to commercially available professional liability insurance. Some firms do not.

The process to obtain appropriately priced professional liability insurance is a long and difficult one. Insurers investigate each firm's quality control system, history of claims and current client composition. They are also acutely aware of the unique risks inherent in audits of public companies, particularly larger ones.

A substantial expansion of a regional or local firm's public company audit practice would undoubtedly result in increased insurance costs, and could result in insurers being unwilling to provide coverage.

Even when coverage is available, it is never possible to insure against the potential catastrophic losses associated with auditing larger public companies.

4) **Liability**

The single most significant deterrent to many accounting firms taking on more public company audits is liability. All public accounting firms are exposed to risk of potential liability for the work they perform. Firms manage that risk in different ways, but the risk is significant nonetheless.

Audits of public companies, especially those of large public companies, carry exponentially greater liability exposure than those of smaller, nonpublic companies. Catastrophic risk, or the risk that a single failure could bring down an entire accounting firm, is also exponentially higher and more frequent in audits of public companies.

For many regional or local accounting firms the practice of auditing public companies is only a small percentage of total firm revenues (*e.g.*, approximately five percent at

BKD) and profitability, and therefore the risk of catastrophic loss is nonexistent or minimal. To further avoid risk, many such firms are very selective in the public companies they accept as clients, avoiding IPOs, start-ups or struggling companies.

Naturally, when considering expanding their public company audit practice, those firms must consider whether they are willing to substantially increase the risk of catastrophic loss, “betting the farm” for what may never be a substantial portion of firm profitability. (Depending on the circumstances, a public company audit practice may not be significantly more profitable than a nonpublic practice, if at all.) In our current litigation environment, many firms may decide that the risk/reward equation is simply out of balance, and they are therefore unwilling to expand their public company audit practices in any meaningful way.

Recommendations

We believe that many regional and local firms are interested in expanding their public audit practices, but generally only for smaller, lower-risk public companies. Before regional and local firms will become interested in substantially increasing their public practices to the extent that their participation would have a meaningful impact on the concentration and competition issue, the risk of catastrophic loss must be addressed.

In recent years, audit firms have been increasingly looked upon as insurers, rather than an integral part of the process of achieving high-quality financial reporting. While audit failures have occurred, and auditors should be held accountable for bad audits, auditors should not necessarily be at risk of catastrophic loss (driven out of business) for failure to detect fraud or even for honest, isolated mistakes. Claims against public accounting firms often have more to do with the clients the firm works for than with the quality of work the firm performs. Accounting firms in the wrong place at the wrong time find themselves a target of litigation in bankruptcy or other organizational failures, simply because they are perceived as an available source from which to recoup losses. While a firm must be able to defend its work, the cost of doing so, even when the work is done well, can be significant.

We believe a limitation of the dollar amount of professional liability claims, such as a multiple of audit engagement fees, would encourage more firms to expand their public company audit practices, be less conservative in their client acceptance and be more willing to audit larger public companies. This fundamental change is necessary to level the playing field and provide adequate incentive for more public accounting firms to increase their participation in public company audits. This is accomplished by:

- 1) *Limiting exposure to catastrophic risk.* More firms would be willing to propose on larger audits if they knew their liability was limited to a specific amount (albeit painful), rather than bearing the exposure to catastrophic loss that threatens the very existence of the firm.
- 2) *Helping maintain insurability.* More firms would be willing to participate in the public company audit market on a larger scale if they were confident in their ability to obtain and retain adequate and affordable professional liability insurance. Certainly, insurance would be more obtainable if losses were capped.

- 3) *Addressing institutional bias.* The potential bias of underwriters, institutional investors and audit committees based on the perception of deep pockets would be lessened by capping potential recoveries, thereby leveling the playing field.
- 4) *Controlling disclosure of confidential information.* Limiting liability would place greater emphasis on the sufficiency of capital and/or professional liability insurance than on firm profitability or partner compensation. More firms would be willing to be transparent with insurance coverage than with other confidential financial information.
- 5) *Potentially reducing overall audit cost.* By reducing the overall costs of accounting firms to defend and settle litigation and by expanding the number of public company audit firms available, the potential exists for audit costs to public companies to be reduced.

While this proposed solution does not address all of the barriers identified above, it does provide significantly more incentive for additional audit firms to expand their presence in public company auditing. With this barrier removed, many firms would be more likely to develop the infrastructure necessary to increase participation in public company auditing.

Some might argue that elimination of the risk of catastrophic (*i.e.*, take the firm down) loss on each engagement would potentially lessen the auditor's rigor in performing consistent quality audits. However, there are several other factors in place to ensure that auditors are conscientious and focused on audit quality. For example:

- 1) *Litigation costs* – even with a liability cap the costs of litigation, including damage awards or settlements associated with audit failures would be substantial (*i.e.*, financially painful) to the firms.
- 2) *Professional reputation* – audit failures are often highly publicized. Smaller firms would likely be even more negatively affected by association with audit failures.
- 3) *PCAOB oversight and enforcement* – multiple instances of poor audit performance would presumably result in loss of PCAOB registration.
- 4) *Possibility of SEC sanctions* on firms and individuals.
- 5) *Ability to obtain/maintain professional liability insurance* – if insurers pay multiple claims for a particular firm, they will quickly eliminate the availability of coverage, thereby driving poor performers out of the public company auditing business.
- 6) *Firm governance and culture*

As a practical matter, we believe that many regional and local firms could, if they desired, expand their public company audit practices to lessen concentration and increase competition among small and mid-size public companies. For the foreseeable future, we do not believe many of these firms, at least not BKD, have the resources to compete for large public company audits.

Financial Transparency

The Committee is considering the need for increased financial transparency of public accounting firms. While this endeavor may shed some light on the ability of public accounting firms to withstand liability claims, the Committee should consider the potential unintended consequences of this effort.

As private enterprises, public accounting firms such as BKD are not required to make internal financial information public. Although firms routinely make certain financial and organizational information available (*e.g.*, revenues, number of personnel, etc.), firm capitalization, profitability and partner compensation are not disclosed for several reasons, including maintaining competitive advantages and protecting the privacy of our partners.

Requiring financial transparency for public company audit firms may deter some firms not currently auditing public companies from even considering such a practice, and could influence some firms with public company audit practices to exit the market to protect their confidential financial information, particularly firms whose public company audit practice comprises a small portion of total revenues.

Public accounting firms vary significantly in their level of capitalization. For smaller firms, the level of professional liability insurance may be far more relevant than other financial information for which transparency is being considered.

We appreciate the opportunity to provide the Committee with our perspective on the issues of concentration and competition among public company audit firms, and look forward to the opportunity to respond to any questions you may have.